

Part III - Administrative, Procedural, and Miscellaneous

Modifications of split-dollar life insurance arrangements

Notice 2008-42

SECTION 1. PURPOSE

This notice provides guidance regarding the application of §§ 101(j) and 264(f) of the Internal Revenue Code (Code) to life insurance contracts that are subject to split-dollar life insurance arrangements. Specifically, this notice provides that a modification of a split-dollar life insurance arrangement that does not entail any change to the life insurance contract underlying the arrangement will not be treated as a material change in the life insurance contract for purposes of §§ 101(j) and 264(f).

SECTION 2. BACKGROUND

Split dollar life insurance arrangements

In general, a split-dollar life insurance arrangement is an arrangement between two or more parties to allocate the policy benefits and, in some cases, the costs of a life insurance contract. Sections 1.61-22, 1.301-1(q), and 1.7872-15 of the Income Tax Regulations provide rules for the taxation of participants in a split-dollar life insurance arrangement. Those regulations generally apply to any split-dollar life insurance arrangement entered into after September 17, 2003. For this purpose, if an arrangement entered into on or before September 17, 2003, is materially modified after

September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification. Section 1.61-22(j)(2)(ii) sets forth a non-exclusive list of changes that are not treated as material modifications for this purpose.

Section 101(j)

Section 101(j) was added to the Code by § 863(a) of the Pension Protection Act of 2006, Public Law 109-280. Section 101(j)(1) generally provides that in the case of an employer-owned life insurance contract, the amount of death benefits excluded from gross income of an applicable policyholder under § 101(a)(1) shall not exceed an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract. For this purpose, an employer-owned life insurance contract is a life insurance contract that (i) is owned by a person engaged in a trade or business and under which such person is directly or indirectly a beneficiary under the contract, and (ii) covers the life of an insured who is an employee with respect to the trade or business on the date the contract is issued. An applicable policyholder is generally a person who owns an employer-owned life insurance contract, or a related person as described in § 101(j)(3).

Section 101(j)(2) provides exceptions to the general rule of § 101(j)(1) in the case of certain employer-owned life insurance contracts with respect to which certain notice and consent requirements are met. Those exceptions are based either on (i) the insured's status as an employee within 12 months of death or as a director, a highly compensated employee or a highly compensated individual; or (ii) the extent to which death benefits are paid to a family member, trust, or estate of the insured employee, or

are used to purchase an equity interest in the applicable policyholder from a family member, trust or estate.

Section 101(j) applies to life insurance contracts issued after August 17, 2006, except for a contract issued after that date pursuant to a § 1035 exchange for a contract issued on or before that date. For this purpose, a material increase in the death benefit or other material change generally causes the contract to be treated as a new contract. Other than as described above, contracts issued on or before August 17, 2006, are grandfathered and not subject to the requirements of § 101(j). See Pub. L. No. 109-280, § 863(d).

Section 264(f)

Section 264(f) was added to the Code by § 1084(c) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34. Section 264(f)(1) provides that "[n]o deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to unborrowed policy cash value" with respect to a life insurance policy or an annuity or endowment contract. Section 264(f)(4) identifies those policies and contracts that are excepted from the rule of § 264(f)(1).

Section 264(f) applies to contracts issued after June 8, 1997, in taxable years ending after such date; any material increase in the death benefit or other material change in the contract is treated as a new contract for this purpose. Other than as described above, contracts issued on or before June 8, 1997, are grandfathered and not subject to the requirements of § 264(f). See Pub. L. No. 105-34, § 1084(d) (as amended by Pub. L. No. 105-206, § 6010).

SECTION 3. APPLICATION OF SECTIONS 101(j) AND 264(f) TO CONTRACTS THAT ARE SUBJECT TO SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

Both §§ 101(j) and 264(f) apply to "life insurance contracts," which are defined in § 7702 for all purposes of the Internal Revenue Code as any contract that is a life insurance contract under the applicable law, but only if such a contract either meets the cash value accumulation test of § 7702(b), or both meets the guideline premium requirements of § 7702(c) and falls within the cash value corridor of § 7702(d). Under § 7702, the term "life insurance contract" generally does not encompass the terms of an arrangement, such as a split-dollar arrangement, of which the contract is a part. Accordingly, if the parties to a split-dollar life insurance arrangement modify the terms of the arrangement but do not modify the terms of the life insurance contract underlying the arrangement, the modification will not be treated as a material change in the life insurance contract for purposes of §§ 101(j) and 264(f), even if the modification is treated as a material modification of the split-dollar arrangement for purposes of § 1.61-22(j).

DRAFTING INFORMATION

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